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Tax Forum

Anne D. Snodgrass

TAX FORUM

ANNE D. SNODGRASS, CPA, Editor
Texas Instruments Incorporated
Dallas, Texas

The Tax Reform Act sections dealing with private foundations are the result of more Congressional study, thought, and literary discourse than any other provisions included in this very complicated legislation. Unfortunately, the result approaches chaos. The provisions are complicated and nearly impossible to interpret. But, nevertheless, they are now a part of the Internal Revenue Code and must be observed.

What Isn't a Foundation

Under the new law any existing 501 (c) (3) organization must notify the Internal Revenue Service that it is not a private foundation; otherwise, it will be presumed to be one. Churches are exempt from these notification requirements; so are public charities with annual gross receipts of $5000 or less, although the Internal Revenue Service has requested that they file anyway. The time for notification does not expire until 90 days after the regulations prescribed under Section 507 become final. Recently a Form 4653 was circulated to all 501 (c)(3) organizations for the purpose of submitting the necessary notification. The cover letter requested that the Form be filed within 30 days. The implication was that failure to file this form would result in an automatic characterization as a private foundation. This is not in accordance with the law. Although the filing of the form indicating a status other than a private foundation is temporary protection to donors and contributors to the organization, failure to file is not fatal.

There is widespread misunderstanding about what constitutes a foundation and/or a private foundation. Many organizations are reveling in the confidence that they are not foundations because they are corporations, or trusts, or some other form of organization. Unfortunately, this is not how the Internal Revenue Service sees it—a foundation can be a corporation, a trust, or any other type of tax-exempt organization that is not specifically excluded from the definition.

To be precise, a private foundation is any 501 (c)(3) organization that is not a church, a school, a hospital, a medical research organization operated in conjunction with a hospital, a governmental unit, an organization operated for the benefit of a college or a university owned by a governmental unit, or an organization that normally received, directly or indirectly, a substantial amount of its support from a governmental unit or from the general public. These organizations are basically the organizations described in Section 170 (b) (1) (A) of the Code and are those to which individuals can make contributions up to 50 percent of their net taxable income.

In addition, the new Code specifically excludes any 501 (c) (3) organization which normally received more than one-third of its support from gifts, grants, contributions, or membership fees and gross receipts from activities which are not unrelated trades or businesses. In making this determination, receipts from any one person to the extent they exceed $5000 or one percent of the organization's total support must be excluded and also any receipts from disqualified persons, from governmental units, and from any of the so-called "50 percent organizations" described above must be excluded. In addition to the public support test, the organization must also receive no more than one-third of its support each year from gross investment income. This type of organization would include symphony societies, garden clubs, Girl Scouts, and many other membership organizations.

The third type of organization which is not a private foundation is one which is organized and operated exclusively for the benefit of or to carry out the purposes of one or more of any of the organizations described above. In order to escape the private foundation characterization it must be controlled by the organization it benefits and must not be controlled directly or indirectly by any substantial contributor or other disqualified person other than one of the foundation managers. A substantial contributor is one who contributes more than $5000 or more than two per cent of the total contributions. The substantial contributor status is cumulative, so any person who has once become a substantial contributor remains one and must never serve in any capacity which would make him a foundation manager (an officer, director, or trustee). The organizations in this category can be operated for the benefit of, or to carry out the purposes of, certain membership organizations other than 501 (c) (3) organizations. For example, the educational foundations and scholarship funds of business leagues, social welfare organizations, and professional organizations will escape the dubious distinction of becoming private foundations under this exclusion.

The final type of organization which is not a private foundation is one which is organized and operated exclusively for testing for public safety.

Annual Tax to Pay the Auditor

Every 501 (c) (3) organization in existence on October 9, 1969, must determine its status as of October 9, 1969. If, on that date, the organization is established to be a private foundation, a 4% excise tax will be imposed on the foundation's net investment income. This tax is supposed to pay the bill for the policing of private foundations by the Internal Revenue Service. In determining net investment income, only gross income from interest, dividends, rents, and royalties, plus net capital gains is taken into account. Ordinary and necessary expenses incurred in the production or collection of the gross income subject to tax are allowable deductions. Depreciation must be deducted on a straight line method only, and percentage depletion is not allowed. In determining taxable capital gains, only gains and losses from disposition of property used for production of gross investment income or unrelated business income are taxable. The basis for determining gain from the sale of property held on December 31, 1969, is its cost or its fair market value on that date, whichever is lower. No capital loss carryovers will be available, so losses can be taken only to the extent of gains during the taxable year.

The 4% audit fee tax is just the beginning. The other taxes imposed on private foundations are penalty taxes designed to prevent certain prohibited transactions, to restrict the activities and investment practices of foundations so that these activities are confined to charitable purposes, and to prevent the use of foundations for personal gain by their creators. There are five categories of prohibited transactions—self-dealing, failure to distribute income, excess business holdings, investments that jeopardize charitable purpose, and certain expenditures.

Taxes on Self-Dealing

Section 503 of the Internal Revenue Code specifies a number of prohibited transactions which are characterized as self-dealing. Arm's-length standards were imposed on these transactions, and failure to comply resulted in loss of exempt status and disallowances of charitable contribution deductions.

New Section 4941 removes private foundations from Section 503 and prohibits self-dealing by imposing taxes on the self-dealer and on any foundation managers knowingly participating in the transactions. The self-dealer is a disqualified person dealing with the private foundation, and a disqualified person is a substantial contributor, a foundation manager, the owner of more than 20 percent of a corporation, partnership, or trust that is a substantial contributor, any member of the immediate family of any of the above, or a corporation or partnership or trust in which other disqualified persons have ownership of more than 35 percent.

The first-level tax is imposed at the rate of 2½% on the foundation manager and 5% on the self-dealer. If the act is not corrected within the prescribed period, a second-level tax at the rate of 200% of the amount involved will be imposed on the self-dealer and 50% on the foundation manager. To correct such transaction, it must be undone to the extent possible or at least the foundation must be placed in a financial condition no worse than if the disqualified person had been acting in the highest fiduciary capacity.

Acts of self-dealing include any of the following transactions between a disqualified person and a private foundation:

(1) sale or exchange or leasing of property;
(2) lending of money or other extension of credit;
(3) furnishing of goods, services, or facilities;
(4) payment of compensation to a disqualified person;
(5) transfer of income or assets of a private foundation; and
(6) any agreement between a private foundation and a government official for the payment of money to such official.

Taxes on Failure to Distribute Income

Unreasonable accumulations of income by charitable organizations have been prohibited in the past under Section 504. Violations resulted in loss of tax exemption. Now under Section 4942 all private foundations except private operating foundations are liable for a penalty tax on failure to distribute income within one year following the taxable year in which it is earned. They are also required to distribute corpus if their income is less than a

(Continued on page 19)

"COMPUTER JOB MATCHING NOW AND TOMORROW, Edward P. Dear, PERSONNEL, Volume 47, Number 3, May-June 1970.

Almost one-fifth of America's total work force will change jobs this year. This mobility has made the employment business big business—private agencies have more than doubled since 1963. The nature of the employment agency has also changed to handle higher salaried professional personnel.

Job retrieval by computer is less than three years old; however, it has already had widespread acceptance as an employment technique. National Personnel Associates has a network of 150 independent placement agencies who handle professionals in a broad range of fields. Each of the member agencies has a Mark II on line remote-access computer terminal in its office.

The National Registry, PICS, and NISARC are three computerized registers who have followed National Personnel Associates into this field. In addition, three private computerized retrieval firms, GRAD, RE-CON, and COMPU JOB, have become factors in college placement. Several pilot programs are in progress by college placement offices who have adopted their own computerized methods to aid in their internal retrieval operations.

The author is executive vice-president of Employment Systems, Inc. He states that leaders in the field predict that in ten years 60 percent of all employment placements will be made by computerized matching.

While we all accept job mobility, if more of the right jobs and right people could be brought together in the first place, job mobility might be less costly.

Dr. Patricia L. Duckworth, CPA
Metropolitan State College at Denver

TAX FORUM

(Continued from page 16)

specified amount; for foundations created before May 27, 1969, the minimum investment return does not apply prior to January 1, 1972. The expenditures must be "qualifying distributions," otherwise they do not count in determining whether or not sufficient distributions have been made. "Qualifying distributions" include those to public charities and private operating foundations, but not to other private foundations. Private foundations must check carefully the status of the organizations to which it makes contributions. Other qualifying distributions or expenditures are those which are made directly for charitable purposes and expenditures for assets to be used for charitable purposes.

The initial tax is imposed at the rate of 15% and is imposed annually until the undistributed income is paid out in a qualified distribution. If a deficiency notice is issued with respect to undistributed income, a second-level tax at the rate of 100% is imposed unless qualifying distributions are made within 90 days after the issuance of the deficiency notice.

Taxes on Excess Business Holdings

Foundations have been used in some cases to maintain control of businesses, with the result that the charitable functions get lost in the press of the business management. This situation was not covered under the old law, but new section 4943 limits the business holdings which a private foundation can own or control.

Permitted holdings are measured by reference to the voting stock of a corporation owned by the foundation in combination with voting stock held by any disqualified persons. Together, no more than 20 percent can be held. However, if all the disqualified persons own no more than 20 percent of the voting stock of a corporation, the private foundation is permitted to hold nonvoting stock. If the corporation is controlled by disinterested third persons, the combined holdings can be as high as 35 percent.

Taxes on excess business holdings are 5% of the value of such holdings at the first level and 200% at the second level, which is imposed where a deficiency notice has been issued and the prohibited act is not corrected.

In addition to the two-level penalty taxes described above, a third-level sanction is imposed in case of willful and flagrant violations. The third-level sanction is essentially a termination tax which requires the repayment of all income, gift, and estate tax benefits which have ever accrued to the foundation or its substantial contributors or its entire net assets.

The March 1971 issue of the Tax Forum will cover the remaining foundation no-no's —that is, prohibited investments and prohibited expenditures. In the concluding installment on private foundations will be summaries of the reporting requirements and requirements for exercising expenditure responsibility as to certain grants.